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Transactional Tax Liability Policies — At the Top of the Adoption Curve?

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With the current and expected increase in distressed mergers and acquisitions (M&A) resulting from Covid-19, either in the bankruptcy context of §363 sales[1] or outside of bankruptcy in expedited transactions, it is worth revisiting tools to provide buyers with protection from transactional risks where sell side indemnities are either scarce or impossible. This article examines transactional tax liability policies, a more recent tool that functions as an alternative to a seller escrow to provide compensation to insured parties in the event of audit or tax controversy.

A long time ago in transaction insurance time (five years ago in real time), there was a little-known product called representation and warranty insurance which certain private equity companies were using to cover representations on their exit from existing businesses in M&A transactions. Generally, only risks that *were not identified in due diligence* are covered (matters identified in due diligence reports are generally excluded). This product had lots of exclusions, took six weeks to put in place, and was in its infancy. Today, the parties to many M&A transactions purchase representation and warranty insurance and many more consider it. Indeed, by some estimates, at least one of the parties (often the buyer) purchases representation and warranty insurance in about ⅓ of all transactions in the United States. Representation and warranty insurance hit a turning point in approximately 2017 when its popularity skyrocketed and its terms, timing and process dramatically improved. It also has led the market to consider other forms of transaction insurance. In particular, tax insurance for specific known risks (matters specifically *identified in due diligence*) has hit the same turning point and it is likely to become, like its bigger brother representation and warranty insurance, a common feature in and outside of transactions. This article seeks to describe tax insurance and its features at a high level and understandable manner, layout the areas where coverage is generally available, and provide thoughts for potential buyers on areas of both opportunity and potential risk.

WHAT IS TAX LIABILITY INSURANCE?

Broadly speaking, tax insurance is available to provide insurance coverage for a known tax risk in the event of audit, assessment, or other required tax payment. Generally, to the extent coverage is desired for unknown tax risks not identified in due diligence, such coverage is provided as part of any broader representation and warranty insurance purchased for the transaction. The product provides financial cover for tax losses (including interest and penalties), defense costs, and any gross-up arising from a successful tax

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Special thanks to Austin Cahill, head of tax at Atlantic Global Risk for market insights and discussions.

[1] 11 U.S.C. §363.

assessment in respect of the known tax risk. On an M&A transaction, the buyer can use the product to fully or partially replace the need for a seller indemnity/escrow or purchase price adjustment in response to diligence findings. This is particularly valuable given the complexity of negotiating escrow and indemnity provisions for periods as long as the statute of limitations is typically applicable to tax matters. Outside of a transaction, tax liability policies have become a tool for sponsors and corporations to manage tax risks and minimize tax reserves by transferring the risk to an insurer. The amount of coverage purchased (the ''Policy Limit'') is determined by the insured party and is typically set at the estimated total tax liability, including any tax, interest, penalties, defense costs, and gross-up (for any increase in taxes as a result of amounts paid under the policy). The product is generally available for the full statute of limitations, including extensions. Tax liability insurance is available in most global locations that are not subject to unrest or extensive tax changes, but subject to underwriter interest. North America, Europe, Singapore, India, Australia, and New Zealand are among the areas where coverage is generally obtainable. Insurers prefer to cover risks in jurisdictions that are politically stable, have an advanced legal system, and a tax authority or tribunal with a recognized process and procedure. Certain exclusions are common in local areas if there is a particular ongoing tax controversy. Tax insurance is therefore best suited to cover tax positions where the relevant taxing authority has not yet issued clear guidance.

Currently, Policy Limits can be as low as $2,500,000 and can rise to over $1,000,000,000 in total covered tax losses. Pricing typically ranges between 2% and 4% of the Policy Limit. This pricing is further confirmation that tax insurance is not designed to cover those tax controversies that are known to be most contentious (i.e., known controversies that typically require the taxpayer to concede far more than 2-4% of the amount at issue or are actively the subject of known enforcement programs). Depending on the nature of the risk, the insured amount may be subject to a risk retention, which is similar to a deductible. This amount is typically (beneficially) restricted to paying a portion of the defense costs.

WHAT IS THE CURRENT PROCESS TO OBTAIN TAX LIABILITY INSURANCE?

Typically, if you obtain a memorandum outlining a particular tax risk and the related factual analysis from a tax advisor (law firm, accounting firm), the memorandum can be provided to a representation and warranty insurance broker who will then use the memorandum to seek quotations for coverage. In certain limited cases, external diligence is not required at all. As long as one advisor is willing to state in a memo or written opinion that the desired treatment is more likely than not, even if other advisors disagree, it may be sufficient to obtain a policy. In rare cases a legal opinion of the tax advisor will also be required. Once quotes are provided by insurance companies, the tax insurance broker assisting on the transaction will provide a report to the proposed insured outlining all insurer terms as well as providing a recommendation, after which the potential insured party will select an insurer and pay an underwriting fee which is typically $30,000-$50,000. At this point the potential insured turns over its diligence related to the issue for underwriting, and an underwriting call occurs where the insured's tax counsel asks questions regarding the potentially insured risks. Generally, privilege as between the insured and the insurer is lost at this stage, but as a result of common interest, such due diligence reports will not necessarily be discoverable in litigation. The underwriting call is an important step in the process. It is a best practice for the insured to include a tax controversy attorney and the underlying tax expert on this call to protect against potential policy exclusions that could come about relating to due diligence concerns or because of relevant administrative and judicial procedure.

In order to increase efficiency, the policy is negotiated simultaneously alongside the underwriting process, with payment occurring shortly after execution (although only a 10% deposit is owed on M&A transactions with split sign and close dates). The underwriting process typically takes 10 business days, but depending on the nature of the risk, can be underwritten more quickly if necessary. Each policy is tailor made to the tax risk at issue. Typically, coverage includes federal, state, and foreign taxes, as well as a gross-up for taxes due on payment of the insurance proceeds. Most policies exclude taxes owed because of fraud (both civil and criminal) or other criminal matters.

WHAT CAN BE COVERED?

The below is a non-exhaustive list of matters which have been frequently covered, other tax risks are also coverable:

- **Qualification & Exemptions**: Treaty Qualification, Real Estate Investment Trust (REIT), S corporations, Passive Foreign Investment Company (PFIC), Unrelated Business Taxable Income (UBTI), Employment Tax Withholding, Foreign Investment Property Tax Act

ISSN 0148-8295

(FIRPTA), §338(h)(10)[2] Elections, Indirect Transfer Tax;

- **Deduction**: Debt/Equity Classification, Worthless Stock Deduction, Net Operating Loss (NOL) Availability, §382/§384 limitations, Ordinary Deduction versus Capitalization;
- **Credits:** Historic Tax Credit, Foreign Tax Credits, Renewable Energy Tax (ITC/PTC), Low-Income Housing (LIHTC), New Markets Tax Credit (NMTC), Recapture, State Tax Credits;
- **Reorganizations & Deferral:** Acquisitive/Divisive Reorganizations, Spin-offs/Split-offs/Spit-ups, Like-Kind Exchange, Deferred Compensation §409A;
- **Transfer Pricing/Valuation:** Insurance coverage is most likely to be available for the pricing of routine functions (e.g., contract manufacturing, distribution). With that said, even transactions related to what a company considers a routine function often times can lead to a contentious dispute with a taxing authority. Whether insurance companies would be willing to insure more contentious transfer pricing issues, such as IP transfers that often lead to valuation disputes in excess of one billion, has to be evaluated on a case by case basis; and
- **Calculation/Other Valuation:** Section 311(b) Gain, NOL Carryforward, Mandatory Repatriation Inclusion (and §965), GILTI Inclusions, Subpart F Inclusion Amount, §83(b) Elections, Qualified Basis.

WATCH OUT AREAS

In addition to the premium payment, there are several areas which require attention to make sure the product is right for potential insureds, particularly those with experienced multi-national tax departments or with internal self-insurance considerations for tax matters.

(1) **Control of Claims**: Generally, the insured specifies their desired tax advisor, which requires consent of the insurer (not to be unreasonably withheld). The insured will retain general control of the tax matter ***except*** that settlement will require the consent of the insurer and the insurer will have the right to participate with its own counsel in all communications (including settlement communications) with the applicable taxation authority. Liability is typically capped at the proposed settlement amount in the event the insured continues litigating after a settlement offer acceptable to the insurer is presented. Additionally, the insured party is generally under obligations to use commercially reasonable efforts to mitigate the loss, and the insurer may be entitled to any offsetting tax benefits obtained by the insured (or an affiliate). If covered and non-covered matters are the subject of one audit, defense costs will need to be allocated between covered and uncovered positions in audits which cover multiple issues.

There is an assortment of issues that could give rise to a conflict between the insurer and insured in the context of control over the claims. This potential for conflict is one the insured should seek to avoid through a carefully negotiated policy. In particular, the insured should be very careful about its obligation to mitigate tax losses in terms of (a) limiting mitigation so it does not restrict the ability to take opposite tax positions from the insured tax position in post-closing tax periods[3] and (b) specifying what is and is not reasonable in terms of when the insurance company can withhold consent to settlement. For example, for issues that potentially give rise to double taxation, the insured should understand its obligation to pursue competent authority relief, which often times is a time consuming and costly process.

(2) **Ability to Take Divergent Positions from the Insured Position Pre-Closing:** Typically, the insurer will exclude any loss arising from the filing of any return or amended return (including a qualified amended return, information return, report, statement, etc.) after the issuance of the policy that is inconsistent with the insured position, unless filed with the prior consent of the insurer (not unreasonably withheld). Further coverage will not be lost if the insured can establish that the insurer was not prejudiced by the inconsistent filing. As discussed above, the ability to change historical practices post-closing may need to be negotiated in the policy and excluded from mitigation limitations.

(3) **Loss of Coverage Following a Change in Law:** Typically, coverage, for periods following

[2] All section references herein are to the Internal Revenue Code of 1986, as amended (the ''Code''), or the Treasury regulations promulgated thereunder, unless otherwise indicated.

[3] For example: If a tax position is identified in due diligence and determined to be sufficiently risky that insurance is purchased, it may be desirable to cease to take that position during post-closing tax periods, which sometimes can alert the authorities that the prior position was risky. By explicitly carving out this ability from the mitigation covenant, a purchaser of the insurance retains more flexibility in its tax positions post-closing.

ISSN 0148-8295

a change in law, does not continue and as such, there is a possibility of some retroactive coverage loss.

(4) **Required Litigation:** The policies generally require that tax liabilities may be litigated and appealed so long as the insurer obtains an independent counsel opinion that there is a more likely than not a chance of success, and unless there has been a change in law or circumstance. As taxpayers value their reputation with revenue services, and often seek to minimize press coverage of their tax positions, this requirement can be onerous. On the other hand, taxpayers also have incentives to litigate the dispute to achieve an acceptable outcome. An insured party in the United States should also understand that the forum for most tax litigation is the U.S. Tax Court and some insurance policies preference litigation at the U.S. Tax Court. One of the advantages of litigating in the U.S. Tax Court is that it does not require the taxpayer to pay the tax until the conclusion of the litigation. Thus, an insurer may be more inclined to litigate because the rules do not require an up-front payment of tax. Nevertheless, taxpayers may prefer to pay an alleged tax deficiency and then sue for a refund in federal district court or the U.S. Court of Federal Claims, where, for example, the controlling case law may be advantageous to the taxpayer. Pursuing refund litigation in those venues may be more challenging with a policy that presses the insured party into the Tax Court.

(5) **Privilege and Disclosure:** It is possible that the process of obtaining coverage results in the loss of tax privilege on the matter and could require public disclosure of such tax policies with securities regulators or stock exchanges; however, insurers can be very flexible in arranging the handling of confidential information in such a way that prevents such required disclosures whenever possible. Careful attention should be given to attorney-client privilege and other protections that may apply in the United States and other relevant jurisdictions before pursuing tax indemnity insurance and disclosing otherwise privileged information to a third-party insurer. Even with the watch out areas noted, tax liability insurance will likely become increasingly common in transactions and particularly in distressed transactions. In fact, the insurance is also obtainable post-closing, which allows a prospective buyer to seek coverage to replace, or supplement, indemnity coverage in competitive situations such as §363 sale bids under the Bankruptcy Code[4] when a company is going through the bankruptcy process for which due diligence and negotiation are often highly time limited.

CONCLUSION

This article provides the relevant facts necessary to quickly assess whether transaction tax liability insurance is a potential solution for a matter at hand based on coverage options, key terms, future restrictions on tax controversy control, and other material considerations. However, interested parties must consider that each policy will still require a degree of customization to match the risk tolerance and strategic priorities of a particular transaction and tax group. As transactional tax liability insurance becomes more prevalent and particularly as it ventures into coverage of more contentious issues likely to face active controversies, it is critical for both the insured and insurance companies to consult with M&A, tax controversy, tax subject matter experts, as well as tax insurance brokers to work towards a solution.

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[4] 11 U.S.C. §363.

ISSN 0148-8295

ISSN 0148-8295

ISSN 0148-8295